

Information Regulation is Tricky: Lessons from Mortgage Disclosure Research

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Part I

Disclosure Policy is Tricky: Overview

Mandatory Disclosures are Everywhere

- Appliances (energy use labels)
- Food products (nutrition and ingredient labeling)
- Motor vehicles (EPA mileage rating, Monroney price sticker, used car warranty disclosures)
- Prescription drugs (patient package insert, direct-to-consumer advertising disclosures)
- Financial transactions (Truth-In-Lending, Good Faith Estimate, and privacy disclosures)

Potential Benefits of Mandatory Disclosures are Substantial

- Educate consumers and prevent deception
- Reduce search costs and facilitate comparison shopping
- Improve consumer decisions
- Promote efficient markets

But Disclosure Policy Is Tricky

- Is the disclosure really needed?
 - Would the information improve consumer decisions?
 - Why isn't market voluntarily supplying information?
- Is the disclosure feasible?
 - Does a valid metric exist to impart information?
- Will the disclosure work as intended?
 - How will consumers interpret and understand disclosure?
 - How will it affect consumer decisions?
 - Will it help some consumers but harm others?
 - Can the intent of the disclosure be circumvented?

Possible Disclosure Pitfalls

- Irrelevant information
- Too much information
- Confusing information
- Misleading information

Potential Costs of Mistakes Are Substantial

- Make information acquisition and processing more difficult and time consuming
- Distort consumer decisions
- Impose unnecessary compliance costs
- Distort firm decisions on product and feature offerings
- Harm competition

Two Types of Research to Estimate Costs and Benefits

- Prior to implementation:
 - Is there evidence that people are likely to interpret the disclosure as intended?
 - What are likely costs and benefits?
- After implementation:
 - How did the disclosure affect consumer knowledge or change consumer behavior?
 - What were the actual costs and benefits?

Part II

Lessons from Mortgage Broker Compensation Disclosure Study

(Pre-Implementation Research)

Lacko and Pappalardo, "The Effect of Mortgage Broker
Compensation Disclosures on Consumers and Competition: A
Controlled Experiment," Federal Trade Commission Bureau of
Economics Staff Report (2004)
<http://www.ftc.gov/os/2004/01/0301/030123mortgagefullrpt.pdf>.

FTC Mortgage Broker Compensation Study Illustrates

- Consumers can understand simple, clear financial disclosures
- But some disclosures can confuse consumers and lead to worse decisions
- Consumer research can help disclosure policy

Proposed Mortgage Broker Compensation Disclosure

- Part of new Good Faith Estimate proposed by HUD in 2002
- Prominent disclosure of compensation paid to the broker by the lender
 - Primarily yield spread premium (YSP) paid for above-par loans
- Proposed to help borrowers shop for mortgages
- Direct lenders exempt

Comparison of Broker and Direct Lender Disclosures

Proposed origination charge disclosures for a hypothetical loan offered by a broker

A. Origination Charges (HUD-1 800 Series)*

\$ 4,000.00

See Attachment A-1 listing origination charge subtotals for the lender and the broker.

B. Interest Rate Dependent Payment (200, 900)***

Until you lock in your interest rate these payments may change.

(1) (+) Borrower Payment to Lender for Lower Interest Rate: \$ _____

(2) (-) Lender Payment to Borrower for Higher Interest Rate: - \$ 2,500.00

NET LOAN ORIGINATION CHARGE DUE FROM BORROWER (Sum of A and B):

\$1,500.00

Proposed origination charge disclosures for the same loan offered by a direct lender

A. Origination Charges (HUD-1 800 Series)*

\$ 1,500.00

See Attachment A-1 listing origination charge subtotals for the lender and the broker.

B. Interest Rate Dependent Payment (200, 900)***

Until you lock in your interest rate these payments may change.

(1) (+) Borrower Payment to Lender for Lower Interest Rate: \$ _____

(2) (-) Lender Payment to Borrower for Higher Interest Rate: \$ _____

NET LOAN ORIGINATION CHARGE DUE FROM BORROWER (Sum of A and B):

\$1,500.00

FTC Staff Concerns about the YSP Disclosure

- Unnecessary (final cost is what matters)
- May confuse consumers (lead to a focus on compensation rather than final cost)
- Result in worse loan choices
- Disadvantage brokers
- Harm competition

Test Setting

- Respondents shown cost information about two mortgage loans
- Asked two main questions:
 - Identify the less expensive loan
 - Loan choice if shopping for a mortgage

Test Loans

- Respondents shown 2 loans using same format
 - One treated as a “broker” loan
 - One treated as a “direct lender” loan
- Followed proposed disclosure policy in YSP disclosure groups
 - Broker loan – YSP disclosed
 - Direct lender loan – YSP not disclosed
- Loans not identified as broker or lender loans

Tests Conducted Twice

- Two loan cost scenarios
 - Broker loan less expensive
 - Both loans cost the same

Five Test Groups

- 3 versions of YSP disclosure tested
 - Differed in wording of disclosure
 - Two different disclosure form formats
- 2 control groups
 - One for each format
 - YSP disclosure omitted

Consumer Sample

- 517 recent mortgage customers
 - Obtained a mortgage in the previous 3 years or currently shopping for a mortgage
 - 103-104 in each of 5 test groups
- 8 locations across the country

Results

Broker Loan Less Expensive Identification of Less Expensive Loan

- Percentage of respondents correctly identifying the less expensive loan
 - Control groups: 89-90%
 - Disclosure groups: 63-72%

Results

Broker Loan Less Expensive Loan Choice If Shopping

- Percentage of respondents choosing the less expensive loan
 - Control groups: 85-94%
 - Disclosure groups: 60-70%

Results

Identical Cost Loans Identification of Less Expensive Loan

- Percentage of respondents:

	<u>Both same</u>	<u>Broker loan</u>	<u>Lender loan</u>
– Control groups:	95-99%	1-2%	0-3%
– Disclosure groups:	49-57%	5-11%	30-45%

Results

Identical Cost Loans Loan Choice If Shopping

- Percentage of respondents:

	<u>Either loan</u>	<u>Broker loan</u>	<u>Lender loan</u>
– Control groups:	78-83%	1-7%	3-7%
– Disclosure groups:	25-30%	5-17%	46-57%

Conclusions

Broker compensation disclosures:

- Reduce the proportion of consumers correctly identifying the less expensive loan
- Reduce the proportion of consumers choosing the less expensive loan if they were shopping
- Lead to a significant anti-broker bias that may have anti-competitive effects on the mortgage loan market

Disclosure Policy is Tricky

- Intention of YSP disclosure:

Help consumers understand loan costs
and obtain less expensive loans

- Effect of YSP disclosure:

Consumer confusion about loan costs and
mistaken choice of more expensive loans

Possible Connections to Behavioral Economics

- Irrational response to “irrelevant information” (although hard to test against simple confusion)
- Loss aversion/endowment effect issues?
 - YSP framed as \$2500 payment from lender to consumer, which broker takes from consumer to cover origination charges

This Does Not Mean that Disclosure Policy Cannot Work

- Simple, clear disclosures can be very effective in conveying important information to consumers
- Illustrated by our control group results
 - About 90% of respondents correctly identified the less expensive loan when one loan had lower costs
 - No bias when loans had identical costs
- Requires careful consideration of what to disclose and how to disclose it

Part III

Current Research to Understand and Improve Consumer Use & Comprehension of Mortgage Disclosures

(Combination of Pre-Implementation and Post-
Implementation Research)

70 Fed. Reg. 3, January 5, 2005, 820-821.

Two Complimentary Methodologies

- Qualitative, in-depth interviews
 - 2 focus groups (2 hour)
 - 36 interviews (1 hour)
- Quantitative consumer testing
 - 819 respondents (30 minutes)
- Both with recent mortgage customers

In-Depth Interviews

- Obtain in-depth picture of consumer mortgage shopping experience
- Assess consumer knowledge of terms of recent loan
- Assess consumer understanding of current loan disclosures (TILA and GFE)
- Obtain consumer reaction to prototype disclosures

Consumer Testing

- Experimental setting with large sample
- Quantitative testing of consumer ability to understand and use mortgage disclosure forms
 - Current forms: TILA and GFE
 - Prototype form: developed for study
- Respondents given disclosure forms for two loans and asked to
 - Identify loan that was less/more expensive on various loan costs
 - Identify whether particular costs/terms present in loan
 - Identify the amounts of various loan costs

Findings

- Current mortgage disclosures fail to convey key mortgage costs to many consumers
- It is possible to design better disclosures that significantly improve consumer recognition of mortgage costs

Part IV

Conclusions & Implications for Behavioral Research

Conclusions

- Designing factual information disclosures that people comprehend as intended is tricky.
- Careful consumer testing is often required to predict the likely effects of information policy, and to assess the ultimate effects of information regulation.

Implications for Behavioral Research

- Consumer decisions that may appear irrational might be explained by poorly designed disclosures, which are misunderstood, rather than faulty decision making.
- Given the difficulty of designing strictly factual disclosures, the difficulties of designing information policies intended to counteract behavioral biases may be even trickier.